United Nations A/67/187

General Assembly

Distr.: General
27 July 2012

Original: English

Sixty-seventh session
Item 18 (b) of the provisional agenda*
Macroeconomic policy questions

International financial system and development

Report of the Secretary-General**

Summary

The present report, submitted in response to General Assembly resolution 66/187, complements the report of the Secretary-General on the follow-up to and implementation of the Monterrey Consensus and Doha Declaration on Financing for Development. It reviews recent trends in the international official and private capital flows to developing countries and current efforts to strengthen the international financial architecture. The report highlights the ongoing challenges arising from the world financial and economic crisis and its aftermath, in particular in the key areas of financial regulation, multilateral surveillance, policy coordination, sovereign debt, the global financial safety net, management of capital flows and governance reform at the Bretton Woods institutions.

* A/67/150.

** The present report was prepared in consultation with staff of the major institutional stakeholders involved in the financing for development process. Responsibility for its contents, however, rests solely with the United Nations Secretariat.

12-44263 (E) 170812

Please recycle

I. International financial flows of developing countries

A. Global imbalances and reserve accumulation

1. The external imbalances of the major economies narrowed substantially during the world economic and financial crisis and, during the past year, appeared to stabilize at about half their pre-crisis levels. The current account deficit of the United States of America fell from a peak of over 6 per cent of gross domestic product (GDP) in 2006 to about 3 per cent of GDP in 2011. The counterparts to the deficit of the United States have been the external surpluses in China, Germany, Japan and some oil-exporting economies, which have narrowed. Most notably, the combination of currency appreciation and rapid growth in domestic demand led to a reduction in the current account surplus of China from about 10 per cent of GDP in 2007 to less than 3 per cent of GDP during the past year. Looking ahead, global imbalances are expected to stabilize around their existing levels over 2012.[1]

2. Despite the recent reduction in global imbalances, they remain an issue of concern to policymakers. For instance, the build-up of large external liability positions by deficit countries, matched by large external asset positions of surplus economies, can potentially lead to exchange-rate instability. Another concern relates to the process of adjustment to the imbalances by major economies, namely, the concurrent reduction of deficits and surpluses, which should not create economic disruption and endanger economic growth prospects. Rather, the requisite adjustment measures should be consistent with the promotion of growth and employment generation in both developed and developing economies.

3. The unprecedented accumulation of foreign reserves by a number of developing country central banks has been an important component of global economic imbalances. In the aftermath of the Asian financial crisis, and recognizing that even well-managed countries could be hit by contagion from elsewhere, many developing countries opted for accumulating foreign reserves, in part as protection against future crises. If countries have higher (net) levels of liquid foreign assets, they are likely to be better able to withstand panics in financial markets and sudden reversals in capital flows. A large proportion of the reserves have been invested in United States treasuries and other low-yielding sovereign papers. The amount of foreign reserves accumulated by developing countries is estimated to total more than $7 trillion in 2011.[1]

4. The build-up of reserves by developing countries, however, does come with high opportunity costs in terms of domestic investment forgone, especially when such build-up of reserves is sterilized. If those nations had not increased their reserve holdings, they could have used the money to support investment in physical or human capital. The cost of the build-up of reserves is the difference between the return on such investments and the small returns on the assets held as reserves.

5. In the longer run, renewed reserve accumulation by developing countries may give rise to widening global imbalances and would imply that one or more reserve-issuing economies would need to accrue larger current account deficits. The International Monetary Fund (IMF) has developed a new metric to assess the

[1] *World Economic Situation and Prospects 2012* (United Nations publication, Sales No. E.12.II.C.2).

adequacy of reserve levels that encompasses a broader range of drains on reserves than imports and external debt. There have also been suggestions for a new global reserve system that allows for better pooling of reserves at regional and international levels and is not based on a single national currency, or even multiple national currencies. One possibility is to employ the IMF special drawing rights (SDRs) for that purpose. The issue of broadening the SDR currency basket remains under consideration, and might eventually lead to a wider acceptance of SDRs and help strengthen their role as an international reserve asset.

6. The accumulation of reserves by developing countries has the effect of transferring financial resources from the developing to the developed world. Developing countries, as a group, are estimated to have made a net transfer of financial resources of approximately $826.6 billion to developed countries in 2011. While still below its peak level of $891.6 billion in 2008, the volume of net financial resource transfers has returned to its traditional growth pattern over the past two years after the sharp drop in 2009 during the global economic crisis. Most of the transfers from developing countries were from upper-middle-income countries, whose net outflows increased by $85 billion to $580 billion in 2011. In contrast, poorer countries continued to have a low level of net positive transfers.[1]

B. Private capital flows to developing countries

7. Following a strong revival in the aftermath of the world financial and economic crisis, net private capital flows to developing countries experienced a downturn during the latter part of 2011. In total terms, they are estimated to have fallen from about $447 billion in 2010 to about $438 billion in 2011.[2] That development was brought about by growing fears among portfolio investors about the sustainability of public finances in Europe, which gave rise to a general "flight to safety". Some stability appeared to have returned during the early months of 2012, as risk aversion among investors eased in line with improving prospects for the euro zone and the global economy at large. The prospects for private capital flows to developing countries over the coming months are mixed. On the one hand, stronger economic fundamentals in emerging economies, combined with continuing economic problems in many advanced economies, should serve to attract investors. There are signs of an economic slowdown in some of the leading emerging economies, however, which, together with renewed concerns about the global economy, could lead to a sharp increase in risk aversion in international financial markets, giving rise to further large swings in private capital flows.

8. While portfolio flows to developing countries rebounded earlier this year, there have been concerns over the possibility of a renewed slowdown. Both equity and bond flows could be affected by developments in the global economy. In addition, some developing economies may be particularly vulnerable to adverse market sentiment owing to concerns that include decelerating growth rates, high fiscal and external deficits and, in some instances, political instability. Looking ahead, a further resurgence in short-term capital flows to developing countries, driven by expansionary monetary policies in advanced economies, could also pose problems by building up new vulnerabilities and increasing the susceptibility of

[2] IMF, World economic outlook database, April 2012 edition. Available from imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx.

those economies to sudden outflows of foreign capital. The earlier surge in capital flows that took place from 2009 to 2011 is argued to have increased the amount of potential hot money in emerging markets that may depart suddenly. Moreover, the strong flows into corporate debt markets during recent years have been accompanied by a rapid expansion in private credit in some developing economies, thereby heightening their vulnerability to rapid deleveraging or a sudden reversal in capital flows.[3]

9. Overall, commercial bank lending to developing countries remained below its pre-crisis levels as leading international lenders have continued to experience financial problems. Recent figures from the Bank for International Settlements indicated a decline in cross-border claims on emerging market economies from banks located in other countries during the latter part of 2011.[4] It was only the second such decline in almost three years and may be indicative of deleveraging by commercial banks, which is likely to continue in the near future. This could serve to dampen the supply of credit to developing and transition countries, while the impact is likely to be greatest in emerging Europe and central Asia, which have the most direct exposure to distressed European banks.[5] There is nevertheless a risk that the deleveraging process could become disorderly and lead to a sharp reduction in credit by those institutions, which could affect a wider range of developing countries. Such a development may in turn trigger significant portfolio outflows from emerging economies, affecting the stability of their currencies and capital markets.

10. Foreign direct investment (FDI) remains a major component of private capital flows to developing countries and is estimated to have amounted to some $376 billion in 2011.[2] Those flows are concentrated in a few developing countries, although there have been signs of greater diversification. Moreover, there are significant regional differences. The large majority of FDI in developing countries continues to be channelled to Asia and Latin America, while flows to Africa, though higher than a decade ago, remain limited.

11. While FDI in developing countries has tended to be more stable and geared towards a longer term than other types of private capital flows, some experts argue that its changing composition may be making it more volatile.[6] The components of FDI constitute equity investment, reinvested earnings and intracompany debt. In general, equity investment tends to be the most stable component of FDI, while intracompany debt is more flexible, depending on the decisions of the parent company to assist in financing the expansion or running costs of its foreign affiliates. Where a significant portion of FDI is intracompany debt, the parent company can recall that debt on short notice. It has been argued that a recent shift in the composition of FDI, from equity to debt components, has made it easier to move capital between host and home countries. Moreover, the proportion of short-term and volatile flows in FDI has increased, and the growth in FDI flows during recent

---

[3] IMF, *Global Financial Stability Report: The Quest for Lasting Stability* (Washington, D.C., IMF Publications Service, 2012).

[4] Bank for International Settlements, *Quarterly Review*, June 2012. Available from bis.org/publ/qtrpdf/r_qt1206.htm.

[5] World Bank, *Global Economic Prospects: Uncertainties and Vulnerabilities*, vol. 4 (January 2012).

[6] United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2011: Non-Equity Modes of International Production and Development* (United Nations publication, Sales No. E.11.II.D.2).

ears has partially served the purpose of short-term gains. For instance, some of the intracompany funds received from the parent company are invested for speculative purposes and may be easily liquidated.

C. Official development assistance

12. In 2011, members of the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD) provided $133.5 billion of net official development assistance (ODA), representing 0.31 per cent of their combined gross national income. That marks a decrease of 2.7 per cent compared to 2010 and the first annual drop in ODA since 1997, when aid fell by 6 per cent (disregarding years of exceptional debt relief). Within total net ODA, aid for core bilateral projects and programmes (excluding debt relief grants and humanitarian aid) fell by 4.5 per cent in real terms.[7] Looking ahead, prolonged recessions in several Committee donors may further squeeze aid budgets while mounting pressure on other donors.[8]

13. The largest donors in 2011 were France, Germany, Japan, the United Kingdom of Great Britain and Northern Ireland and the United States. Denmark, Luxembourg, the Netherlands, Norway and Sweden continued to exceed the United Nations ODA target of 0.7 per cent of gross national income. In real terms, the largest increases in ODA were registered in Italy, New Zealand, Sweden and Switzerland. By contrast, ODA fell in 16 out of 23 Development Assistance Committee countries mostly as a result of fiscal constraints related to the current crisis. The largest cuts happened in Austria, Belgium, Greece, Japan and Spain. Continued commitment and political will in some countries helped partially offset this trend. Seven countries — Australia, Germany, Italy, New Zealand, the Republic of Korea, Sweden and Switzerland — increased their aid in 2011. The United Kingdom remains on track to reach 0.7 per cent of its gross national income by 2013.

14. Whereas bilateral aid to sub-Saharan Africa was $28.0 billion in 2011, representing a fall of 0.9 per cent in real terms compared to 2010, aid to the African continent increased by 0.9 per cent to $31.4 billion, as donors provided more aid to North Africa following the political upheavals in the region. The least developed countries also saw a reduction in net bilateral ODA flows of 8.9 per cent in real terms to a total of $27.7 billion in 2011. It falls further below the internationally agreed target of 0.15-0.20 per cent of donors' gross national income. The top 10 recipients of ODA were Afghanistan ($6,374 million), Ethiopia ($3,529 million), the Democratic Republic of the Congo ($3,413 million), Haiti ($3,076 million), Pakistan ($3,021 million), the United Republic of Tanzania ($2,961 million), Viet Nam ($2,945 million), India ($2,807 million), the Occupied Palestinian Territory ($2,519 million) and Iraq ($2,192 million).[9]

---

[7] OECD Development Assistance Committee, "Aid statistics". Available from oecd.org/dac/aidstatistics.

[8] OECD Development Assistance Committee, "Outlook on aid: survey on donors' forward spending plans 2012-2015". Available from oecd.org/development/aideffectiveness/50056866.pdf.

[9] OECD Development Assistance Committee, "Development aid at a glance, statistics by region: developing countries, 2012 edition". Available from oecd.org/dac/aidstatistics/42139479.pdf.

15. Aid flows remain unpredictable and volatile, as shown by their unexpected fall in 2011. Moreover, ODA delivered through multilateral agencies is not received immediately. Country programmable aid provides a useful measure of actual ODA receipts by developing countries. For 2011, it is provisionally estimated at $93.1 billion, which represents a fall of 2.4 per cent compared to 2010. This decline mostly affects countries in Central America as well as some large aid recipients in South-East Asia (e.g., Indonesia and the Philippines). It is estimated that country programmable aid will increase by 6 per cent in 2012 but mainly owing to expected increases in outflows of soft loans from multilateral agencies from earlier capital replenishments (2009-2011). From 2013 to 2015, country programmable aid is expected to stagnate, reflecting a delayed impact of the global economic crisis.

16. Other sources of development finance, including official assistance from non-members of the Development Assistance Committee, private philanthropy and innovative mechanisms, continue to rise. Donations by non-members of the Development Assistance Committee that informed OECD of their aid flows reached $7.2 billion in 2010. The biggest donor was Saudi Arabia, accounting for almost half of the total. It is estimated that private assistance in 2010 amounted to $56 billion. Innovative financing for development is characterized by official sector involvement, international cooperation and cross-border transfer of resources to developing countries; innovation in the type of resources, collection, or governance structures; and additionality over ODA. In all, an estimated $5.8 billion in health financing and $2.6 billion in financing for climate and other environmental protection programmes have been managed through such mechanisms since 2002. In general, innovative development financing mechanisms have fulfilled specific purposes, such as front-loading ODA disbursements, mitigating risks and incentivizing the commercialization of new vaccines.[10]

II. Strengthening the international financial architecture

A. Reform of financial regulation

17. The international community continued to pursue the reform agenda that had been set out in response to the weaknesses in financial regulation and oversight exposed by the global financial crisis. The overall goal of the reform efforts is to enhance the resilience, transparency and capitalization of the international financial system. In addition to efforts undertaken at the national and regional level in countries with major financial sectors,[11] the focus at the international level is on implementing the Basel III framework, strengthening the regulation of large financial institutions and expanding the regulatory perimeter to the shadow banking system and markets for over-the-counter derivatives.

18. The Basel III framework for bank capital and liquidity regulation, issued in December 2010, provides for higher minimum capital requirements, better risk capture, higher quality of capital and larger liquidity buffers. In addition, the

[10] See report of the Secretary-General on innovative mechanisms of financing for development (A/66/334), and *World Economic and Social Survey 2012: In Search of New Development Finance* (United Nations publication, Sales No. E.12.II.C.1).

[11] Examples include the *Dodd-Frank Wall Street Reform and Consumer Protection Act* in the United States and regulatory reform initiatives in the European Union.

framework combines micro- and macroprudential elements to address both institutional and systemic risks. It is foreseen that the Basel III requirements will be gradually phased in by 2019. According to the Basel Committee on Banking Supervision, the adoption of the Basel III rules under national law was planned or under way in all 27 member jurisdictions of the Basel Committee as at March 2012.[12] In addition, the framework is expected to be implemented in numerous countries that are not members of the Basel Committee.

19. It has been suggested, however, that the changes envisaged in the Basel III framework might be too small to sufficiently enhance the resilience of financial institutions against systemic shocks. According to some assessments, capital requirements should be significantly higher than those stipulated by Basel III.[1] Indeed, several countries have imposed higher capital requirements for important banks in their jurisdictions. Emerging markets and developing countries have also expressed concerns about the complexity of Basel III, which would pose challenges to their capacity to implement the new regulations, monitor implementation, and address potential unintended consequences for their financial systems.[13]

20. Despite amendments to the Basel III framework,[14] there are continuing concerns over the implications of the new rules for trade finance. The Basel III rules might increase bank capital and other requirements for trade finance facilities, such as letters of credit, and therefore significantly affect the availability and cost of such instruments. It is crucial to avoid such adverse impacts in the process of defining and calibrating the new requirements and to continue dialogue with all stakeholders concerned, in particular with a view to ensuring the participation of developing countries in international trade.

21. Large financial institutions were found to have spread systemic risks during the global financial crisis.[15] Group of 20 leaders therefore agreed to strengthen the oversight and regulation of systemically important financial institutions, in particular of global systemically important financial institutions. The international effort to address systemically important financial institutions focuses primarily on minimizing the adverse impacts their distress or failure might have on the financial sector as well as on the broader economy. In November 2011, the Financial Stability Board, in cooperation with the Basel Committee, identified an initial group of 29 global systemically important financial institutions.

22. The Financial Stability Board developed a set of policy measures to address systemically important financial institutions.[16] A key element of the measures is that global systemically important financial institutions should have a loss-absorbing capacity beyond the general standards promulgated by the Basel III rules. The

---

[12] Basel Committee on Banking Supervision, *Progress Report on Basel III Implementation*, (Basel, Bank for International Settlements, 2012).

[13] Financial Stability Board, "Identifying the effects of regulatory reforms on emerging market and developing economies: a review of potential unintended consequences", 19 June 2012. Available from financialstabilityboard.org/publications/r_120619e.pdf.

[14] Basel Committee on Banking Supervision, *Treatment of Trade Finance under the Basel Capital Framework* (Basel, Bank for International Settlements, 2011).

[15] UNCTAD, *Trade and Development Report 2011, Post-crisis Policy Challenges in the World* (United Nations publication, Sales No. E.11.II.D.3).

[16] Financial Stability Board, "Policy measures to address systemically important financial institutions", 4 November 2011. Available from financialstabilityboard.org/publications/r_11110466.pdf.

measures put forward by the Board also aim at establishing more intensive and effective supervision of all systemically important financial institutions. While those measures represent important progress to tackle risks associated with large financial institutions, the view has been expressed that those risks are not yet adequately addressed in the present framework.[17] It has also been argued that the financial system continues to be highly concentrated, and that large financial institutions should be restructured by pursuing an antitrust approach.

23. There is an ongoing effort to enhance the monitoring and regulation of the shadow banking sector (i.e. credit intermediation through non-bank channels such as money market and other funds). Such entities can provide alternative, market-based sources of funding, but can also pose risks to the financial system. In October 2011, the Financial Stability Board issued principles for the monitoring of shadow banking,[18] which set out an assessment process for the relevant authorities regarding the nature and potential impact of non-bank credit intermediation in the financial system. In addition, the Board has enhanced the monitoring of shadow banking activities and will develop recommendations for further regulatory action in a number of specific areas in 2012.

24. The significant increase in over-the-counter derivatives, that is, a group of innovative financial instruments traded outside a formal securities exchange, is considered to have played a destabilizing role during the global financial crisis. Their notional amount outstanding grew almost six-fold over the past decade and amounted to $649 trillion in December 2011, corresponding to about 10 times world GDP.[19] International regulatory and standard-setting bodies have intensified work to improve the regulation and transparency of over-the-counter derivatives markets, including through requirements for the reporting and central clearing of transactions.[20]

25. Other regulatory initiatives under discussion include work on accounting standards, compensation practices,[21] financial market infrastructure, data gaps and financial consumer protection.

26. Despite some progress, formal representation in international financial regulatory bodies, such as the Bank for International Settlements, the Basel Committee and the Financial Stability Board, continues to be limited to advanced and some major emerging-market economies. The governance structures of those bodies should be reviewed with a view to enhancing the participation of developing countries and economies with smaller financial sectors.

---

[17] "World economic situation and prospects as of mid-2012" (E/2012/72).

[18] Financial Stability Board, "Shadow banking: strengthening oversight and regulation", 27 October 2011. Available from financialstabilityboard.org/publications/r_111027a.pdf.

[19] Bank for International Settlements, "Semiannual OTC derivatives statistics at end-December 2011", available from bis.org/statistics/derstats.htm; World Bank, "World development indicators", available from http://data.worldbank.org/data-catalog/world-development-indicators.

[20] Jaime Caruana, General Manager, Bank for International Settlements, "Building a resilient financial system", statement to the Asian Development Bank Financial Sector Forum, Manila, 7 February 2012. Available from bis.org/speeches/sp120208.pdf.

[21] Krishnan Sharma, "Financial sector compensation and excess risk-taking: a consideration of the issues and policy lessons", Department of Economic and Social Affairs Working Paper No. 115, April 2012.

27. The success of international financial regulatory reform depends on the timely, comprehensive and globally consistent implementation of the policies. The establishment of the Financial Security Board framework to monitor the implementation of regulatory reforms is therefore a step in the right direction. Efforts in a number of regulatory areas remain works in progress, however, and require further detailing. Moreover, significant implementation challenges remain to avoid regulatory arbitrage and create a global regulatory level playing field. Better coordination between national regulators will be crucial in this regard. In addition, the phasing in of most regulatory changes over a rather long period of time has been identified as a weakness of the reform process.

B. Multilateral surveillance and policy coordination

28. Efforts have continued to strengthen the capacity of multilateral surveillance to identify risks to global financial and economic stability in a timely and comprehensive manner. An important priority in this process has been the focus on cross-border and cross-sectoral linkages, which involves enhancing the ability to assess the impact of policies and shocks in major economies on other countries and regions, as well as paying more attention to linkages between the financial sector and the real economy. Shortcomings in those areas had been identified as gaps in IMF surveillance in the run-up to the global financial and economic crisis.

29. IMF has taken a number of steps to strengthen the quality and coverage of its surveillance activities. In 2011, the Fund prepared, for the first time, spillover reports for the world's five largest economies (China, Japan, the United Kingdom, the United States, and the euro zone) to better reflect interconnections between the world's economies. The reports assessed the impact of policies in those economies on their partner economies. The findings were summarized in a consolidated spillover report, which stressed the importance of financial channels for transmitting global shocks and, therefore, the positive effect of policies tackling financial stress.[22] IMF also cooperates closely with the Group of 20 in the mutual assessment process on whether their policies support balanced and sustainable global growth. In addition, work is under way at the Fund to further reform and broaden its surveillance approach, including by bringing a multilateral perspective to bilateral surveillance, and by sharpening the focus on cross-country spillover effects, risk assessment and financial and external stability risks, as suggested by the Fund's 2011 Triennial Surveillance Review and the related Managing Director's Action Plan. The International Monetary and Financial Committee, at its meeting held in April 2012, agreed that the current surveillance framework should be significantly enhanced.[23]

30. The monitoring by IMF of global stability risks emanating from financial sectors has been strengthened by the decision to make financial stability assessments at five-year intervals a mandatory part of surveillance for the 25 jurisdictions with systemically important financial sectors. Under the revamped IMF/World Bank Financial Sector Assessment Programme, several systemically

[22] IMF, "Consolidated spillover report: implications from the analysis of the Systemic-5", July 2011. Available from imf.org/external/np/pp/eng/2011/071111.pdf.

[23] International Monetary and Financial Committee, "Communiqué of the twenty-fifth meeting of the IMFC", 21 April 2012. Available from imf.org/external/np/sec/pr/2012/pr12145.h.m.

important financial sectors are to be assessed in 2012.[24] Moreover, enhancing collaboration between the Fund and other relevant institutions in financial sector surveillance, such as the Financial Stability Board, the Bank for International Settlements and financial sector standard-setting bodies, continues to be a priority.

31. In addition to an increased focus on interlinkages and systemic risks, the effectiveness of surveillance relies on an adequate process to follow up on identified risks. While IMF has been strengthening the follow-up to surveillance recommendations, different options to further enhance the international commitment to take into account the repercussions of domestic policy decisions on global stability should be kept under consideration. They could include, for instance, mandatory consultations and the possibility of incentives and sanctions in cases of non-compliance with internationally agreed policies.[25] It was also emphasized, in particular by developing countries, that the effectiveness of surveillance depends on the quality and even-handedness of the analysis and advice provided.

32. The coordination of financial and economic policies at the international level is crucial to safeguard global financial stability. In the wake of the crisis, an important priority of the Group of 20 has been to set up a framework for economic policy coordination. At their summit in Cannes, France, in November 2011, Group of 20 leaders adopted the Cannes Action Plan for Growth and Jobs. The Action Plan aims to address short-term vulnerabilities in the financial system and strengthen medium-term foundations for growth, such as through fiscal consolidation and boosting domestic demand in countries with large current account surpluses to advance global rebalancing. Building on this process, Group of 20 leaders, at their summit in Los Cabos, Mexico, in June 2012, further adopted the Los Cabos Growth and Jobs Action Plan. A view was expressed, however, that the collective action is not comprehensive enough and is limited to an aggregation of policy measures that countries are planning on their own terms. It is argued that the momentum of cooperative action needs to be regained, and that more decisive international cooperation and better coordination are necessary to tackle pressing financial and economic challenges (see E/2012/72).

33. Many United Nations Member States, in particular small countries, remain excluded from the Group of 20 process, although their economies are affected by the decisions taken by this informal grouping. Discussions towards a stronger and more inclusive framework of global economic governance should therefore be advanced (see A/66/506). The central role of the United Nations in addressing the relationship between global economic governance and development has been emphasized.

C. Coping with developed country sovereign debt crises

34. Many stakeholders perceive the rising trend in sovereign indebtedness as unsustainable. With the average public debt ratio for developed economies having already surpassed 100 per cent of GDP, several developed economies have received

[24] IMF, "Big financial sectors under review in 2012 by IMF", *IMF Survey Magazine*, 13 January 2012. Available from imf.org/external/pubs/ft/survey/so/2012/pol011312a.htm.

[25] Jack T. Boorman and André Icard, "Palais Royal Initiative — reform of the international monetary system: a cooperative approach for the twenty-first century" in *Reform of the International Monetary System: The Palais Royal Initiative*, Boorman and Icard, eds. (Washington, D.C., Emerging Markets Forum, 2011).

downgrades by credit rating agencies. There have been various policy interventions at the national and regional levels to reduce public debt, with mixed results. Fiscal austerity measures are projected to reduce budget deficits in the euro zone, but deficits are expected to widen further in other major developed economies. The effectiveness of fiscal austerity measures is also affected by the interdependence between economic growth and public debt ratios. Premature fiscal austerity measures can slow down economic growth to a degree that may worsen public debt.

35. Other policies that have been implemented to reduce the adverse impacts of sovereign debt crises include measures to lower sovereign borrowing costs, enhance credit demand from firms and consumers and provide greater rescue funds in times of crisis. In that context, monetary expansion has taken place in major economies through large central bank purchases of sovereign bonds. In the euro zone, the European Central Bank has launched two longer-term refinancing operations since December 2011, which provided commercial banks with three-year loans at an interest rate of 1 per cent. The European Council further introduced the European Stability Mechanism, which provides the euro zone with €500 billion (about $628 billion) in rescue funds. At their summit in June 2012, euro zone leaders agreed on a more flexible use of the Mechanism, including the possibility of directly recapitalizing banks. Moreover, the newly adopted Fiscal Compact will allow the European Court of Justice to fine member countries not adhering to European Union budgetary guidelines. At the international level, many assistance measures were complemented by IMF facilities. The results have been mixed. While, for example, longer-term refinancing operations succeeded in raising demand for sovereign debt and bringing down borrowing costs for some economies from crisis levels, the additional liquidity has not yet trickled down to the firm and consumer level and remains largely in the financial system.

36. International financial stability against the background of substantial public debt could further improve through the establishment of international statutory mechanisms to both facilitate timely debt restructuring and provide greater clarity of the rules by which sovereign debt restructuring will occur. The international community should continue to explore possible measures to enhance the effectiveness of the debt restructuring process and, as a result, improve the efficiency of global capital markets and reduce losses faced by creditors, sovereign borrowers and others adversely affected by the uncertainty surrounding disruptive debt crises.[26]

37. The world financial and economic crisis, followed by the euro zone sovereign debt crisis, has shaken confidence in credit rating agencies. There are concerns that credit rating agencies may exacerbate pro-cyclicality during a crisis through rapid or overzealous downgrading of previously investment-grade instruments. Moreover, the downgrades may have spillover effects and lead to greater borrowing costs even for borrowers whose credit rating has not changed. Root causes for the failure of rating agencies to accurately assess the creditworthiness of certain borrowers have been attributed to conflicts of interest, lack of competition and methodological problems. Conflicts of interest may arise since it is the borrower and not the investor who pays for the rating. This contractual arrangement leads to an incentive for the rating agency to provide the best possible rating in order to maintain the

[26] See Department of Economic and Social Affairs, "Expert Group Meeting on sovereign debt restructuring", 18 May 2012. Available from un.org/esa/ffd/msc/2012Egm_debt/index.htm.

business relationship. Suggested remedies include to return to investor-paid ratings or to subject rating agencies to regulatory oversight and to publish rating performance on a regular basis.

38. Another criticism relates to the notion that the small number of rating agencies would impede the healthy competition that spurs important innovations for rating methodologies. If the "conflict of interest" challenge persists, however, more rating agencies may simply lead to a race to the bottom with more liberal and less reliable ratings. While the incentive and competition challenges seem to be of paramount importance, it is also the methodological flaws, especially in the rating of sovereign debt, that must become part of public debate. In the United States, policy action has included the 2006 Credit Rating Agency Reform Act, while at the international level the International Organization of Securities Commissions has published its Code of Conduct. In the European Union, the European Securities and Markets Authority recently established regulatory technical standards for credit rating agencies, the objective being to ensure a level playing field, transparency and the adequate protection of investors across the European Union and contribute to the creation of a single rule book for financial services.[27] Other proposals include obligating rating agencies to get permission for new rating methodologies. While more transparency is welcome, it is also important that those types of obligations not disincentivize rating agencies from revising old methodologies in favour of more diverse approaches.

D. Global financial safety net

39. Amid continuing financial instabilities, steps have been taken to strengthen the global financial safety net. The multilateral capacity to provide liquidity in times of systemic crises represents a crucial factor in safeguarding global financial stability. In addition, a reliable global financial safety net reduces the incentive for countries to accumulate reserves in order to cope with adverse shocks.

40. In 2012, resources available to IMF for crisis prevention and resolution were significantly reinforced. A number of countries committed themselves to provide an additional $456 billion for this purpose. Those resources will be in addition to quota increases under the IMF 2010 quota review and previously enhanced borrowing arrangements of the Fund with member countries and central banks. It was stressed that the additional resources will be available for the whole membership of IMF and not be earmarked for any particular region.

41. IMF continued to reform its liquidity and emergency lending facilities. In November 2011, the Precautionary Credit Line was replaced by the Precautionary and Liquidity Line, which is designed to meet more flexibly the liquidity needs of member countries with sound economic fundamentals and some remaining vulnerabilities. In addition, the Fund's instruments for emergency assistance were consolidated under the new Rapid Financing Instrument, which may be used to support a range of urgent balance-of-payments needs.

[27] European Securities and Markets Authority, "Publication of the first regulatory technical standards on credit rating agencies (CRAs)", 30 May 2012. Available from esma.europa.eu/news/Publication-first-regulatory-technical-standards-credit-rating-agencies-CRAs.

42. The international financial safety net has continued to evolve towards a multilayered structure comprising global, regional and bilateral components.[28] The overall size of the collective safety net, however, remains small in comparison to reserves accumulated by national central banks. Moreover, there continues to be a lack of a global mechanism ensuring the swift and sufficient availability of substantial resources to stabilize market conditions in times of systemic liquidity crises. Efforts to further strengthen crisis-lending facilities should therefore focus on enhancing the different layers of the financial safety net as well as strengthening the coordination and consistency between the mechanisms at different levels. In that regard, a stronger role for IMF in the coordination and management of the overall system might be envisaged.

43. The G-20 Principles for Cooperation between the IMF and Regional Financing Arrangements, endorsed by Group of 20 leaders at the meeting in Cannes in November 2011, recognized that enhanced cooperation between IMF and regional financial arrangements would be a step towards better crisis prevention and resolution. The financial and operational capacity of mechanisms in different regions has been reinforced, as in the euro zone or in East Asia. In May 2012, the members of the Association of Southeast Asian Nations plus China, Japan and the Republic of Korea (ASEAN+3) under the Chiang Mai Initiative agreed to double the size of their emergency liquidity programme to $240 billion and make it more readily available.[29]

44. It is recognized that the bulk of liquidity needed to ease funding pressures during the financial crisis was provided through a series of ad hoc arrangements among key central banks. The involvement of major central banks will remain pivotal for a functioning and sufficient global financial safety net. Calls for the creation of a more permanent framework of liquidity lines between key central banks should therefore be given consideration. It has been argued that the existence of such agreements, even in times of limited usage, has a stabilizing effect. Moreover, it is deemed important to ensure that such arrangements do not constrain the monetary policy and operational frameworks of participating central banks.[30]

E. Management of capital flows

45. The increasing volatility and vulnerability of private capital flows to changing investor sentiments have rendered it increasingly important for countries to have the scope to employ measures to effectively curb volatile short-term capital flows. The policy instruments that may be employed by countries to manage international capital flows are usually divided into three categories: (a) macroeconomic policies, (b) macroprudential measures and (c) other forms of capital account regulations,

[28] See, for instance, Pradumna B. Rana, "The evolving multi-layered global financial safety net, role of Asia", S. Rajaratnam School of International Studies Singapore Working Paper No. 238, 16 May 2012.

[29] Naoyuki Shinohara, IMF Deputy Managing Director, "Reforming international financial safety nets", statement to the Asian Development Bank Forty-fifth Annual Meeting, Manila, 5 May 2012. Available from imf.org/external/np/speeches/2012/050512.htm.

[30] Benoit Coeure, Member of the Executive Board of the European Central Bank, "Unexpected events and the global safety net", statement to the IMF/Swiss National Bank High-level Conference on the International Monetary System, Zurich, 8 May 2012. Available from ecb.int/press/key/date/2012/html/sp120508_2.en.html.

including capital controls. The latter directly target capital flows, whereas the macro tools focus on overall economic variables and the domestic regulatory framework.[1]

46. At the macroeconomic level, the policy options include exchange rate, monetary, fiscal and structural policies to enhance an economy's capacity to absorb capital inflows. The downside of these policy measures is that they may not be sufficiently targeted to stabilize financial flows and that they may have undesired side effects. Interventions in the foreign exchange market may result in the unwanted accumulation of foreign exchange reserves. Letting the exchange rate appreciate can adversely affect export-oriented sectors, while tightening fiscal and monetary policies to avoid overheating may constrain domestic demand and jeopardize economic recovery and growth.

47. Macroprudential measures aim at limiting the build-up of systemic vulnerabilities caused by excessive capital inflows and could take the form of balance sheet restrictions (e.g., limiting foreign exchange positions of banks), measures to maintain sound lending standards, such as imposing caps on loan to value ratios, or introducing countercyclical capital buffers aimed at slowing down credit expansion.[31] According to research at IMF, macroprudential measures to stem capital inflows and reduce excessive credit growth have had mixed results. While they appear to have lengthened the maturity of capital inflows in some countries (such as Croatia, Peru and the Republic of Korea), the effect on total net flows was limited. The apparent lengthening in the maturity of capital inflows in the above-mentioned countries has helped to reduce maturity mismatches in the banking system, however, and thereby enhanced the resilience of the financial sector.[32]

48. Overall, the evidence seems to suggest that while macroprudential measures are useful tools to mitigate the impact of volatile capital flows, there should not be excessive or exclusive reliance on them. They should in general be viewed as part of a package that includes sound macroeconomic policies and, in some instances, capital account regulations. The effectiveness of macroprudential measures in addressing volatile cross-border capital flows might also be limited by the fact that, unlike capital account regulations, they may not be sufficiently targeted to the source of the shocks.

49. Capital account regulations come in two varieties, price based or quantity based. Price-based measures, including imposing a tax on inflows or outflows or enforcing unremunerated reserve requirements, serve to alter the price of cross-border capital flows. Quantity-based measures include quantitative limits on certain types of cross-border capital transactions and minimum stay requirements on capital inflows.[33] During the past few years, a number of developing countries (including Brazil, Indonesia, Peru, the Republic of Korea and Thailand) have introduced capital account regulatory measures to contain volatile short-term capital flows.

50. The effectiveness of capital account regulations largely depends on the specific circumstances of a country, which include the economic situation, the

[31] While microprudential measures address the risk of failure of individual financial institutions, macroprudential measures deal with systemic risk.

[32] IMF, "Managing capital inflows: what tools to use?" Staff discussion note, 5 April 2011. Available from imf.org/external/pubs/ft/sdn/2011/sdn1106.pdf.

[33] Pardee Center Task Force, *Regulating Global Capital Flows for Long-Run Development* (Boston University, 2012).

quality of the existing regulatory framework, the structure and persistence of inflows, and the design and implementation of capital flow management measures. For instance, while most studies find that capital account regulations have in many cases successfully changed the composition of inflows away from short-term debt, the impact on longer-term flows has varied; the measures appear to have more success in some cases than in others. This suggests that the design of regulations needs to take into account the specific circumstances of individual countries.[1]

51. IMF has been working to develop a framework to help countries deal with large cross-border capital flows. A set of Fund considerations regarding the use of capital account regulations proposes that country authorities may wish to use such regulations when the exchange rate is not undervalued, the level of reserves is more than adequate, and there are signs of economic overheating. In addition, when capital account regulations are used, IMF suggests that the controls preferably not discriminate between residents and non-residents. Moreover, measures need to be tailored to the risks generated by volatile cross-border capital flows and should be withdrawn when they are no longer required. The Fund also states that the design of capital controls needs to be tailored to country circumstances.[34] Finally, IMF asserts that temporary regulations on capital outflows can be useful in crisis or near-crisis conditions, but only as a supplement to more fundamental adjustments in policies.[35]

52. Nevertheless, some aspects of the Fund's framework have generated discussion. For instance, it has been argued that capital account regulations should be seen as an essential part of the macroeconomic policy regime, evidence having been cited of countries that have effectively employed them alongside other macroeconomic and macroprudential measures. It has also been argued that the regulations should be seen not as solely temporary measures but as permanent tools that can be applied countercyclically to changing economic circumstances. Finally, some experts argue for attaching greater importance to capital outflow restrictions which, among other things, may be a significant deterrent to volatile and harmful short-term inflows.[32]

53. A set of conclusions for the management of capital flows was endorsed by Group of 20 leaders during their 2011 summit in Cannes. In particular, the Group of 20 document reiterated that there was no one-size-fits-all approach or rigid definition of conditions for the use of capital flow management measures.[36]

F. Governance reform at the Bretton Woods institutions

54. Both IMF and the World Bank have taken important steps to move towards a more representative, responsive and accountable governance structure. IMF approved quota and governance reforms in 2010 under the Fourteenth General Review of Quotas, which will double the quotas of member countries and shift more than 6 per cent of quota shares to emerging-market and developing countries

[34] IMF, "Recent experiences in managing capital inflows: cross-cutting themes and possible policy framework", IMF Board paper, 14 February 2011, available from imf.org/external/np/pp/eng/2011/021411a.pdf; and "Managing capital inflows: what tools to use?".

[35] IMF, "Liberalizing capital flows and managing outflows", IMF Board paper, 13 March 2012. Available from imf.org/external/np/pp/eng/2012/031312.pdf.

[36] Group of 20, "G20 coherent conclusions for the management of capital flows drawing on country experiences", November 2011. Available from g20.utoronto.ca.

without lowering the quota shares and voting power of the poorest members. The review will lead to an Executive Board with two fewer seats for advanced European countries and two more seats for emerging countries, which will reflect the change in quota shares. As part of the agreement, all Executive Directors will also be elected. It was also agreed that the composition of the Board will be reviewed every eight years, starting when the quota reform takes effect. In that context, developing countries have called for a third chair for sub-Saharan Africa in place of a chair held by an advanced country.[37]

55. The reforms will not come into force until three fifths of IMF members with 85 per cent of voting rights ratify the change. As at June 2012, however, several member countries, including the Fund's largest shareholder, have not yet ratified the quota reform. Speedy ratification of the reforms has become more urgent with the declared goal to bring forward the Fifteenth General Review of Quotas to January 2014. In that context, the International Monetary and Financial Committee, in its most recent communiqué, has reaffirmed the urgency of making the 2010 quota and governance reforms effective by the 2012 annual meetings.[22]

56. A comprehensive review of the current quota formula will be concluded by January 2013. On 7 March 2012, the Executive Board of IMF initiated formal discussions on the review of the quota formula. Discussions point to a wide convergence of views with regard to the importance of agreeing on a simple and transparent quota formula that better reflects members' relative positions in the world economy and protects the voice and representation of the poorest members. The discussions have touched upon a number of issues, including the relative importance of market GDP versus purchasing power parity GDP in the GDP blend variable, options for better capturing financial openness, economic vulnerability and financial strength, the scope for capturing members' financial contributions and the use of compression to moderate the role of size in the formula and better protect the voice of smaller members and low-income countries.

57. The second phase of governance reform for the World Bank Group, agreed on in April 2010, increases the voting power of developing countries and countries with economies in transition by an aggregate 4.59 percentage points in the International Bank for Reconstruction and Development (IBRD) (since 2008) to 47.19 per cent; by 6.07 percentage points in the International Finance Corporation to 39.48 per cent; and by about 6 percentage points in the International Development Association to 45.59 per cent. The rise in voting shares of developing and transition economies has helped to make the World Bank more open, transparent and accountable.[38]

58. In the case of IBRD, however, including only low-income and middle-income countries (using the Bank's own categorization), the shift from high-income countries to low- and middle-income countries was 3.71 percentage points, taking the share of the latter from 34.67 per cent to 38.38 per cent, while high-income countries retained more than 60 per cent. In that context, the next shareholding review in 2015 should aim for a further increase in the voting power of low- and middle-income countries in the Bank's efforts towards a transparent, dynamic and

[37] Group of 24, "Communiqué", 19 April 2012. Available from g24.org/Communiques/Com2012_april.html.

[38] IMF/World Bank Development Committee, "Communiqué", 21 April 2012.

rules-based voting power formula and protecting the share of the smallest poor countries.[39]

59. For the Bretton Woods institutions, an open and transparent senior leadership selection process that is based on merit irrespective of nationality and gender, as well as the promotion of greater management and staff national diversity, remain important objectives to enhance legitimacy and credibility. In that context, developing countries welcomed the fact that, for the first time in the history of the World Bank, there was an open process for the selection of the President that involved a debate on the priorities and future of the institution. Future selection processes should build on this progress.[36]

III. Conclusions

60. **While the external imbalances of the major economies stabilized at about half their pre-crisis levels during the past year, they remain a matter of concern to policymakers. Global imbalances and the related accumulation of foreign reserves by a number of developing countries led to a significant net transfer of financial resources from the developing to the developed world. Net private capital flows to developing countries experienced a downturn during the latter part of 2011. Moreover, 2011 marked the first annual drop in net ODA (in real terms) from OECD Development Assistance Committee member countries for many years. Both private and official capital flows to developing countries remain unpredictable and volatile.**

61. **The focus of financial regulation at the international level has been on implementing the Basel III framework, strengthening the regulation of large financial institutions and expanding the regulatory perimeter to the shadow banking system and markets for over-the-counter derivatives. The success of international financial regulatory reform depends on the timely, comprehensive and globally consistent implementation of policies in these areas.**

62. **IMF has taken a number of steps to strengthen the quality and coverage of its surveillance activities, including an increased focus on cross-border and cross-sectoral linkages. Work is under way at the Fund to further reform and broaden its surveillance approach. The effectiveness of IMF surveillance would also be enhanced if it were backed by an adequate follow-up process. Better cooperation and coordination of financial and economic policies at the international level is necessary to tackle pressing financial and economic challenges.**

63. **International financial stability could further improve through the establishment of international statutory mechanisms to both facilitate timely debt restructuring and to provide greater clarity of the rules by which sovereign debt restructuring will occur. Regulatory measures should be explored to improve credit rating agencies and their capacity to accurately assess the creditworthiness of borrowers.**

[39] World Bank, "World Bank Group voice reform: enhancing voice and participation of developing and transition countries in 2010 and beyond", staff background document for the Development Committee Meeting, 19 April 2010. Available from http://siteresources.worldbank.org/DEVCOMMINT/Documentation/22553921/DC2010-006(E)Voice.pdf.

64. While steps have been taken to strengthen the global financial safety net, the available collective resources remain small in comparison to the reserves accumulated by national central banks. A key element in strengthening the global financial safety net is closer cooperation between IMF, national central banks and regional and subregional mechanisms. In this regard, a stronger role for IMF in the coordination and management of the various layers of the global financial safety net system might be envisaged.

65. While macroprudential measures are useful tools to mitigate the impact of volatile capital flows, they should in general be viewed as part of a package that includes sound macroeconomic policies and, in some instances, capital account regulations. The effectiveness of capital account regulations largely depends on the specific circumstances of a country. There is no one-size-fits-all solution and the use and design of capital account regulations should take into account the specific circumstances of individual countries.

66. The Bretton Woods institutions have taken important steps to move towards a more representative, responsive and accountable governance structure. The 2010 governance reforms need to be implemented in a timely manner. Future selection processes for the heads of the Bretton Woods institutions should build on the recent open selection process of the World Bank President.